Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-1850-01
[redacted] ID# [redacted]

date: 5/24/01

to: LMSB Group [redacted]
Attn: [redacted]

from: Associate Area Counsel (LMSB) Area [redacted]

subject: [redacted]
EIN: [redacted]
Involving Subsidiary: [redacted]
Cycle: [redacted] through [redacted]
Advisory Opinion

This responds to your memorandum requesting advice on costs incurred by the above-referenced taxpayer for rebuilding [redacted] during the years at issue. This memorandum also follows several telephone conversations between Team Coordinator [redacted] and the undersigned regarding this issue. This memorandum also includes information in response to a memorandum dated January 18, 2001 from Team Manager Jim DeLacey to Associate Area Counsel Ben de Luna titled "Ingram Case - T.C. Memo 2000-323" in which Mr. DeLacey raised various questions regarding the "expense v. capitalization" issue with respect to "overhauls" of various types of equipment.

ISSUES

1. Whether expenses incurred by the above-referenced taxpayer's subsidiary during each of the taxable years [redacted] through [redacted] for rebuilding [redacted] are capital expenditures or currently deductible costs of repair?

2. Whether the position of the Service relating to the capitalization of costs relating to the rebuilding or "overhaul" of assets such as the asset described in Issue No. 1 above has materially changed since the Tax Court issued its opinion in Ingram Industries, Inc. v. Commissioner, T.C. Memo 2000-323, and the Service published Rev. Rul. 2001-4 on December 21, 2000?

CONCLUSIONS

1. The costs incurred by the taxpayer for rebuilding the [redacted] at issue are capital expenditures, not currently deductible costs of repair.

2. The position of the Service on categorizing costs incurred by a taxpayer for rebuilding/overhaul of a capital asset has not changed in any material way; resolution of that issue still requires intense development of the facts and application of established law to the specific facts of the particular asset involved. Rev. Rul. 2001-4 does reflect a change in Service practice in that, under certain circumstances, discussed further below, the Service will not automatically consider all costs incurred during certain types of "maintenance procedures" (which fall between "routine maintenance" and complete overhaul) as capital expenditures; costs associated with this type of "mid-level" procedure (which is described further below) must now be allocated between deductible expenses and capital expenditures, even though they were all incurred during the same procedure.

FACTS

This issue involves [redacted], a subsidiary of the taxpayer and a member of the consolidated group which filed the returns currently under examination. [redacted] (hereafter sometimes referred to as "the taxpayer") operates an [redacted] plant in [redacted] at which raw materials [redacted].

While the actual [redacted] process is much more complex, the following should serve as an adequate overview of the [redacted] process for purposes of understanding the issue with which the Service is faced in this case. [redacted]

Repair/replacement of these [redacted] is not at issue in this case.

The use of , , , and are used up during that process, the taxpayer must constantly to keep the moving.

has a dedicated building which houses furnaces (" "). These furnaces are used exclusively to bake the above-described . These furnaces, known as " ", " ", and " " became operational during , , and respectively. Total costs for building these furnaces, including everything from excavation to roofing, was approximately $ for , $ for , and $ for .[2]

While each of the furnaces was built at a different time and at a different cost, each furnace is very similar in design and construction. Each furnace is made up of a series of cross-over walls, head walls, tub walls, flues, and pits. Each furnace has sections; each section is comprised of "pits". A pit is the cavity in which the are placed, the pit is heated and the is baked. Each furnace thus has pits. Each pit has a refractory lining, made out of fire brick, which serves to protect the metal outside walls of the pit from damage due to the extreme heat which is generated during the process.

It is the expenses which the taxpayer incurs during the periodic rebuilding of parts of this refractory lining which is

---

[1] The emits negative ions.

[2] As we understand the facts, all of the furnaces are contained in the same building, the taxpayer apparently "added on" to the building with the construction of each new furnace.

the subject of this memorandum. At least one wall in each pit contains a flue (there are a total of [redacted] flues per furnace), which is essentially a duct or passage through which flows natural gas. The flues are made out of brick; they are literally built into a furnace wall as an integral part of the refractory lining.

The baking process begins when a pit is loaded with [redacted]. The [redacted] are then packed [redacted]. Natural gas is fired into the flues through "peep holes" (there are [redacted] peep holes per flue), the gas is ignited, the pits are heated and the [redacted] are baked. The [redacted] process proceeds in cycles as follows:

1. loading of [redacted];
2. pre-heating;
3. firing of the flue;
4. cooling;
5. unloading of the [redacted].

The furnace sections are fired on a rotational basis, so that some are being loaded as others are being unloaded. Once baked, the [redacted].

The life of each flue within the refractory lining of the carbon bake furnaces is directly related to the number of cycles for which it is used. The heating and cooling of the pits over the course of the baking causes the bricks which make up the flue to bow or warp.[3] This bowing or warping distorts and "pinches" the flue, which in turn cause firing or draft problems for its respective pit. These problems obviously affect the efficiency of the process; it is thus necessary to periodically rebuild the flues.

The flues are rebuilt only when they fail; in other words, the pit is used continuously until bowing/warping causes the flue and the pit to be so inefficient that rebuilding is absolutely necessary. When this failure occurs, the pit is removed from the firing rotation and the flue walls are rebuilt to "like new" condition. The taxpayer states that it typically did not engage

---

[3] This bowing or warping appears to primarily involve the flue walls; the other walls, which do not contain the flue cavity, do not appear to require frequent replacement.

in "patchwork" of the walls; rather the entire flue wall was rebuilt when needed.

Information provided by the taxpayer indicates that the flue walls have useful lives ranging from [redacted] to [redacted] years. The lives of flues on inside walls are shorter than the lives of the flues on outside walls. During the taxable years under examination, [redacted] incurred costs for rebuilding the flues (in all [redacted]) in excess of $[redacted] in [redacted], $[redacted] in [redacted] and $[redacted] in [redacted].

The taxpayer claimed a current deduction for these costs on its tax returns, claiming that the flue rebuilding is "similar to the repairs made to towboat engines in the Ingram Industries case and/or similar to situation 1" in Rev. Rul. 2001-4. The examination team proposes to disallow the deduction and to require the taxpayer to capitalize these expenses with a MACRS deduction over a three-year life. This is the basis on which the Service and the taxpayer have agreed to settle this issue for the prior audit cycles ([redacted] through [redacted]), said settlement occurring prior to the opinion of the Tax Court in Ingram Industries, Inc., and the issuance of Rev. Rul. 2001-4.

Team Manager [redacted] has also asked us to address, within the context of this opinion, whether the issuance of the above-referenced Tax Court opinion and Revenue Ruling have changed the manner in which the Service should approach the capitalization v. expense issue in the context of rebuilt/overhauled assets.

ANALYSIS

General Law

Section 162 of the Internal Revenue Code allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Such deductible expenses include "incidental repairs." Treas. Reg. § 1.162-1(a). A deduction for the cost of incidental repairs that **neither materially add to the value of the property nor appreciably prolong its useful life**, but keep it in an **ordinarily efficient operating condition** are allowable as a deduction. Treas. Reg. § 1.162-4 [Emphasis Added]. That regulation also provides that the cost of repairs in the nature of replacements that **arrest deterioration and appreciably prolong the life** of the

property must be capitalized and depreciated, rather than expensed.

I.R.C. § 263(a) provides that no deduction is allowed for (1) any amount paid for new buildings or permanent improvements or betterments made to increase the value of any property or estate or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. Treas. Reg. § 1.263(a)-1(b) provides that capital expenditures (i.e., not currently deductible) include amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt property to a new or different use. That regulation also provides that amounts paid or incurred for incidental repairs and maintenance of property within the meaning of section 162 and Treas. Reg. § 1.162-4 are not capital expenditures.

The United States Supreme Court has specifically recognized that the "decisive distinctions [between capital and deductible expenditures] are those of degree and not of kind." Therefore, a careful examination of the particular facts of each case is required. Deputy v. Du Pont, 308 U.S. 488, 496 (1940), *quoting* Welch v. Helvering, 290 U.S. 111, 114 (1933). In order to determine whether certain costs constitute capital expenditures rather than deductible repair or maintenance expenses, "it is appropriate to consider the purpose, the physical nature, and the effect of the work for which the expenditures were made." American Bemberg Corp. v. Commissioner, 10 T.C. 361, 376 (1948), *aff'd* 177 F.2d 200 (6th Cir. 1949).

Any properly performed repair, despite being routine, could be considered to prolong the useful life and increase the value of property if it is compared with the situation existing immediately prior to said repair. Thus, courts have, over the years articulated a number of ways to distinguish between deductible repairs and non-deductible capital improvements. For example, in Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926), *acq.*, 2 C.B. 2, the Tax Court explained that deductible repair and maintenance expenses are incurred for the purpose of keeping the property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use. In Estate of Walling v. Commissioner, 373 F.2d 190, 192-193 (3rd Cir. 1966), the Third Circuit Court of Appeals

explained that the relevant distinction between capital improvements and deductible repairs is whether the expenditures were made to "keep" or to "put" the property in an ordinary efficient operating condition. If to "keep", the expenditure is deductible as a repair or maintenance; if to "put", the expenditure is capital in nature.

In Plainfield-Union Water Company v. Commissioner, 39 T.C. 333, 338 (1962), *nonacq. on other grounds*, 1964-2 C.B. 8, the Tax Court stated that if the expenditure merely restores the property to the state it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful, or more longer-lived, than such an expenditure is usually considered a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent improvement in the longevity, utility, or worth of the property.

Generally, expenditures which are made to **replace** numerous parts of an asset are considered capital. However, if the replacements are of a **relatively minor portion** of the physical structure of the asset, or of any of its major parts, such that the asset as a whole has not gained materially in value or useful life, then the costs incurred may be deducted as incidental repair or maintenance expenses. *See*, Rev. Rul. 2001-4, 2001-3 I.R.B. 1. *See also*, Buckland v. United States, 66 F.Supp. 681, 683 (D. Conn. 1946) (costs to replace all window seals in factory building constituted deductible repairs). The same conclusion holds true even if the minor portion of the asset is replaced with new and improved materials. *See, e.g.*, Badger Pipeline v. Commissioner, T.C. Memo. 1997-457 (costs to replace 1000 feet of pipeline in a 25-mile section of pipeline were deductible repairs, regardless of whether the new pipe was of better quality or has a longer life).

If, however, a **major component** or a **substantial structural part** of an asset is replaced and, as a result, the asset as a whole has increased value, life expectancy, or use, then the costs of the replacement must be capitalized. *See, e.g.*, Denver & Rio Grande Western Railroad Company v. Commissioner, 279 F.2d 368 (10th Cir. 1960) (costs incurred to replace major portions of a viaduct were capital expenditures); P. Dougherty Company v. Commissioner, 159 F.2d 269, 272 (4th Cir. 1946) (costs to replace stern section of barge with new materials were capital expenditures); Stark v. Commissioner, T.C. Memo. 1999-1 (costs to replace building roof were capital expenditures); Rev. Rul. 88-57, 1988-2 C.B. 36, *modified by* Rev. Rul. 94-38, 1994-1 C.B. 35 (costs to perform rehabilitation of railroad freight train cars

as part of a plan of rehabilitation in which structural components were either reconditioned or replaced were capital expenditures) and TAM 9618004 (January 23, 1996) (entire cost of "major inspection" of aircraft engines constitutes a capital expenditure rather than ordinary and necessary business expense).

Of more immediate relevance to the instant case are two Tax Court opinions, Vanalco Inc. v. Commissioner, T.C. Memo. 1999-265 and Ruane v. Commissioner, T.C. Memo. 1958-175. The issue in Ruane was whether costs incurred in "reconditioning" coke ovens represented deductible repairs or capital expenditures.[4] Recognizing that this issue is "factual", the Tax Court looked at the work which was actually performed during the reconditioning of the ovens. The Court found that the reconditioning at issue consisted of rebuilding of the oven walls and relining the walls with fire brick. Reconditioning each of the taxpayer's 230 ovens was necessary every three to four years since the extreme heat of normal use caused the oven walls to crack and break. The ovens were used until the walls were no longer suitable (i.e. used to failure) and were closed while being reconditioned. Eight to ten of the taxpayers' ovens were always shut down for reconditioning.

The Ruane Court determined that the reconditioning of the oven walls was a capital expenditure rather than a deductible expense. The Court found that rebuilding the walls not only prolonged the useful life of the ovens, but in fact "gave them a new life." T.C. Memo. 1958-175, 181. In so holding, the Court noted that, absent the rebuild, the oven could be used for only three to four years and that it would, at that point, be in such a state of deterioration that it was necessary to shut it down. The Court did not consider the cost of rebuilding the walls relative to the costs incurred in building the walls when they were new.

In Vanalco, T.C. Memo. 1999-265, an opinion issued during August of 1999, the Tax Court considered whether costs incurred in rebuilding various parts of an aluminum smelting pot line were deductible or must be capitalized. Among the costs at issue in that case were costs of (1) repairing worn cell linings in smelting cells[5] and (2) replacing the brick floors in the cell

---

[4] Though Ruane involved the 1939 Internal Revenue Code, the considerations regarding this issue are the same as under the modern Code.

[5] These are the [redacted] linings of the [redacted] as described above for the instant case.

rooms with cement floors. The Court found that costs associated with both of these replacement activities constituted capital expenditures and were therefore not deductible.

The Vanalco Court found that the cell linings performed a function which was vital and integral to the smelting process and that the cell linings, while not a asset separate from the cell unit itself, had a useful life which was **independent** of the useful life of the cell unit as a whole. The Court also noted that the cell lining material constituted a "very substantial" portion of the cell unit and that the cost of the lining as a percentage of the total cost of the cell unit (22 per cent of the cost of a rehabilitated cell unit) was "substantial".

With respect to replacement of the brick floor with a new cement floor, the Vanalco Court focused on the fact that the old brick floor was worn out, that patching was not a practical alternative to replacement, and that the new concrete floor was a substantial improvement over the old bricks. The Court thus found that the replacement cost associated with the floor was a capital expense since it was not merely a repair that kept the cell room in an ordinarily efficient operating condition; rather, the new floor made the cell room more valuable to the taxpayer. The Court did not consider the cost of replacing the floor as a percentage of the total cost of a cell unit.

As is clear from the above-referenced cases, while the high cost of the work performed may be considered in determining whether an expenditure is capital in nature, cost alone is not dispositive. *Compare* R.R. Hensler Inc. v. Commissioner, 73 T.C. 168 (1979), *acq. in result*, 1980-2 C.B. 1 (the fact that taxpayer's expense in repairing flood-damaged equipment was large does not change its character as an ordinary and necessary business expense) *and* American Bemberg Corporation v. Commissioner, 10 T.C. 361 (1948) (deduction allowed for drilling and grouting to prevent cave-ins even though the total cost of the expenditures exceeded $1.1 million) *with* Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1 (1979) (costs to dragline an irrigation ditch were capital expenditures, in part because they could be as high as the cost to construct a new ditch) *and* Stoeltzing v. Commissioner, 266 F.2d 374, 376 (3rd Cir. 1959) (expenditures could not be incidental repairs because they exceeded by almost 200% the cost of the entire building).

The characterization of any cost as a deductible repair or capital improvement also may depend on the context in which the cost is incurred. Specifically, where an expenditure is made as

a part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance. United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968). Whether a general plan of rehabilitation exists, and whether a particular repair or maintenance item is part of it, are questions of fact to be determined based upon all of the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done. Id. at 690. The existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine. *See*, Moss v. Commissioner, 831 F.2d 833, 842 (9th Cir. 1987) *and* Vanalco, T.C. Memo. 1990-265.

In general, the courts have applied the plan of rehabilitation doctrine to require a taxpayer to capitalize otherwise minor deductible repair and maintenance costs where the taxpayer has a plan to make substantial capital improvements to property and the repairs are incidental to that plan. In other words, if the otherwise deductible repairs and maintenance costs are incurred in connection with a capital improvement, the cost of the entire improvement process must be capitalized. *See*, Rev. Rul. 2001-4, paragraph 23 and the cases cited therein.

On the other hand, the courts and the Service have not applied the plan of rehabilitation doctrine to situations where the plan did not include substantial capital improvements and repairs to the same asset, where the plan primarily involved repair and maintenance items, or where the work was performed merely to keep the property in an ordinarily efficient operating condition. *See*, Rev. Rul. 2001-4, paragraph 24 and the cases cited therein.

This Case

Applying the above law to the facts of the case at hand indicates that expenses incurred for the purpose of rebuilding the flues/walls every few years constitute capital expenditures rather than deductible expenses. As with the costs incurred by the taxpayer for reconditioning coke ovens in Ruane, the rebuilding of the flues and refractive walls of the [redacted] oven pits was done only when the existing walls/flues had been used to failure. At the time of replacement, the oven was no longer useable for its intended purpose; had the taxpayer not incurred the expenses of rebuilding the walls/flues, it would have had to cease using the pits altogether. Thus here, as in

Ruane, the work done on the flues not only prolonged the useful life of the pits, it actually gave the pits a "new life".

While not an asset separate from the [redacted] ovens as a whole, the refractory lining (which includes the flues) in the instant case, like the cell linings in the Vanalco case, have a useful life which is separate and distinct from the useful life of the ovens themselves.[6] Clearly, the flues/walls at issue last no longer than seven years under normal operating circumstances; in fact, rebuilding the flues/walls is a constant and ongoing process, with several pits closed down at any one time for rebuilding. Like the Vanalco cell linings, these flues/walls are a vital and integral part of the [redacted] process.

Application of the Vanalco cost analysis to the costs at issue in the instant case also adds strong support to the position of the Service that these costs should be capitalized. Based on the costs incurred by the taxpayer in constructing the [redacted] ovens, the refractory lining (for all of the [redacted] pits per furnace) cost approximately $[redacted] to build in [redacted] (the year during which [redacted] II was built), and $[redacted] to build in [redacted] (the year during which [redacted] III was built), an average cost per pit of $[redacted].[7] It appears that the seemingly large difference in cost between [redacted] II and [redacted] III can be attributed, over and above inflation, to a difference in the size of the pits and

---

[6] It is relevant to our determination that the taxpayer treated the refractory linings as a separate asset from the other components of the [redacted] for accounting purposes. We also note that, pursuant to prior agreement with the Service relating to an agreed adjustment for a prior cycle, the taxpayer has agreed to treat the linings as a separate asset for tax purposes as well.

[7] These amounts are based on an evaluation of the original cost list which was provided by the taxpayer in response to the audit team's inquiry and includes installation and supply of the refractory materials. The list for [redacted] II further breaks down these numbers into supplies and labor, with about [redacted] percent of the total cost of the refractory lining consisting of the cost of labor for that oven. The list of costs of constructing [redacted] I, which was also supplied by the taxpayer, was not itemized to the extent that we could determine the specific costs attributed to the refractory lining in the oven pits. For purposes of this opinion, we have utilized only the information which is available.

their attendant refractory linings. The costs listed include not only the costs of the flues, this is the cost of the entire refractory lining, including the headwalls, crossovers and the other walls, which do not include flues.

During the years under examination ([redacted] through [redacted], the taxpayer replaced a total of [redacted] flues at an aggregate cost of $[redacted] an average cost of just over $[redacted] per flue.[8] Thus, the cost of rebuilding the flues during the years at issue averaged almost [redacted] percent of the average cost of building the entire refractory lining $[redacted] versus $[redacted]. It is worth noting in this regard that the costs at issue include costs associated only with the rebuilding of the flues, not the rest of the pit walls, the headwalls and the crossovers. Thus, rebuilding the flues clearly constitutes rebuilding of a "very substantial" portion of the refractory lining and the cost of the rebuild as a percentage of the total cost of the refractory lining is "substantial". *See*, Vanalco, T.C. Memo. 1999-265.

Based on the above, we believe that it is clear that the flue rebuilding costs at issue in this case must be capitalized.

Current State of the Law

At issue in Ingram Industries, Inc. v. Commissioner, T.C. Memo 2000-323, was whether costs for maintenance performed on tugboat engines, while still in the boat, constitute deductible repair/maintenance expenses or capital expenditures. In ultimately deciding that the costs at issue in Ingram were deductible expenses, the Tax Court first determined that, based upon the specific procedures at issue in that case, the engines were not separate assets; they were instead part of the tugboat as a whole. Thus, the Court determined in Ingram that it must consider the extent of the work performed from the perspective of the boat as a whole.[9] It is worth noting that the Ingram Court distinguished the facts of that case from an engine overhaul during which the engine was removed from the boat, in which case the Court inferred that the engine would be considered as a

---

[8] These numbers were taken from Team Coordinator [redacted]'s spreadsheet entitled "[redacted]".

[9] We note that this is unlike the situation presented by the instant case, where the refractory lining is itself a separate asset, booth because of the nature of the asset and the manner in which it was treated by the taxpayer.

separate asset. As should become clear from the following discussion, we believe this distinction is crucial.

The Ingram Court next applied its view of the evidence introduced at trial of that case to established law (the Court made no "new law") to determine that the taxpayer's costs for "inspection and maintenance" of the engines (as opposed to "overhaul" of the engines) were deductible repairs/maintenance rather than capital expenditures. The government chose not to appeal this case. No Action on Decision has yet been issued, though the lawyers who tried the case for the Service have recommended nonacquiescence. While this office does not necessarily agree with the Court's findings of fact in this regard, we do not believe that this case represents a change in the law (though it may be seen as an indication that the courts are more willing to consider factual arguments regarding this issue than they have been in the past).

The facts as found by the Ingram Court, based upon the evidence presented in that case, can be summarized as follows:

Factor	Towboats, per Ingram Court
Unit of property: Does evidence support treating engine as separate asset?	No
Cost of new asset (the "asset" per the Court is the entire towboat)	$6.25 million
Cost of used asset	$2.2 - $2.3 million
Cost of new engine	$1.5 million
Cost of used engine	$600,000

Factor	Towboats, per Ingram Court
Cost of maintenance/ overhaul procedure at issue in case	$100,000
Cost of procedure compared to cost of new asset	1.6%

Cost of procedure compared to cost of used asset	5%
Cost of procedure compared to cost of new engine	7%
Cost of procedure compared to cost of used engine	17%
Number of parts in engine	576
Number of parts replaced	119
Number of parts reused	457
Percentage of parts replaced	20.7%
Percentage of parts reused	79.3%
Useful life of asset	40 years
Useful life of engine	40 years
Time between procedures	3 - 4 years
Time asset is out of service to perform procedure	10 - 12 days
Was procedure performed when engines were completely serviceable (i.e. prior to failure)?	Yes

Based upon these findings of fact, the Court found that the procedure at issue did not change the use or ability of the asset (the boat as a whole), did not prolong the useful life of the asset or the engine and that the procedure did not "add value" to the asset or to the engine. The Court thus determined that the costs of the "maintenance procedure" in Ingram were deductible as costs of incidental repair/maintenance.

It is important to understand that, though the Service sought to classify the procedure at issue in Ingram as an "overhaul" of the engine, the Court specifically found that the facts did not support this characterization. Rather, the Court determined that the procedure at issue was "more in the nature of

preventative maintenance". In fact, the Court specifically distinguished the procedure before it from a procedure known as a towboat "repowering", during which the engine is removed from the hull for a "complete overhaul". A repowering procedure takes 3 - 5 months, costs $200,000 (which would be 3% of the cost of a new towboat, 9% of the cost of a used towboat, 13% of the cost of a new engine, and 33% of the cost of a used engine), is performed near the end of the engine's useful life and brings each engine component part back to original specifications for new parts. Though not specifically stated, the Court implies that expenses for such a complete "repowering" would be capital rather than currently deductible. We note also that the taxpayer in the Ingram case has conceded that repowering expenses are in fact capital; only the in-boat procedure was before the Court in that case.

As stated above, we do not believe that Ingram represents a change in the law. Rather, it represents a circumstance where the taxpayer chose to litigate a procedure which could arguably be seen as either capital or deductible and was able to persuade the Tax Court that the procedures were a routine part of a maintenance program designed to keep the towboats in good working order. This case does, however, provide the Service with an expanded blueprint of how these cases should be developed factually. In the future, we believe that the Service will need to analyze all cases of this type using the factors listed above, as well as any other evidence which may be relevant with respect to any particular asset. As is discussed in the prior section, we believe that analysis of these factors in the present case leads to the clear conclusion that the expenses incurred to periodically rebuild the flues are capital expenditures.

Rev. Rul. 2001-4, 2001-3 I.R.B. 1, which was published on December 21, 2000, considers whether the cost of "heavy maintenance" procedures performed on airframes (i.e. jet airplanes, excluding the engines) is capital or currently deductible. The Rev. Rul. considers three separate scenarios, the first of which did not involve the replacement of any major components or substantial structural parts of the aircraft. The Rev. Rul. determined that the cost of this procedure was currently deductible as routine maintenance.

In the second scenario, in addition to performing the "routine maintenance" described in the first scenario, the airline replaced a "significant portion" of the airframe's skin panels, which "in the aggregate represented a substantial structural part of the airframe". The Rev. Rul. determined that the cost of replacing the airframe's skin, along with various

other work which was deemed to be capital in nature (upgrades, including fire protection, addition of an air phone system and ground proximity warning systems), must be capitalized. The Rev. Rul. holds, however, that the "mere fact that these capital improvements were made at the same time that the work described in [scenario 1] was performed ... does not require capitalization of the cost" of the work described in scenario 1 under the plan of rehabilitation doctrine since the airline's plan in scenario 2 was not to rehabilitate the aircraft, but "merely to perform discrete capital improvements to the airframe." This distinction thus requires that the Service, before relying on the plan of rehabilitation doctrine (described above), must either determine, based upon the facts, that all of the work performed during a procedure is in accordance with a plan of rehabilitation, or, if it is unable to do so, segregate the costs of and allow a current deduction for, any routine maintenance(i.e non-capital) work which is performed at the same time.

The third scenario discussed in Rev. Rul. 2001-4 involves a heavy maintenance procedure performed on the airframes which involves all of the work done in the first two scenarios, plus replacement of major components and structural parts "that materially increased the value and substantially prolonged the useful life of the airframe." In contrast to the second scenario, the "extensiveness of the work performed" in this scenario triggers the plan of rehabilitation doctrine, so costs of "routine maintenance" procedures which may be performed at the same time need not be segregated; all of the costs must be capitalized.

In sum, we do not believe that the recent opinion/ruling discussed herein mean in any way that you should not be raising this issue. Rather, we believe that the Service must be careful to establish all relevant facts before determining whether costs of repair/replacement/overhaul/maintenance of assets is deductible or must be capitalized. Those facts must be analyzed along the lines of the above discussion before any adjustments are proposed. As always, this office will gladly provide whatever assistance is desired in determining what facts are relevant in a particular case, avenues to explore in gathering the facts, and/or analysis of the facts once gathered.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

Please feel free to contact the undersigned at [redacted], to discuss the above or any other aspect of this case.

[redacted]
ASSOCIATE AREA COUNSEL (LMSB)
[redacted]

By: [redacted]
Senior Attorney (LMSB)

cc: [redacted]